



# APPRAISAL BULLETIN

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## SELECTION OF CAPITALIZATION RATES

**W**HAT is the correct capitalization rate today? Capitalization rates are not quoted daily in the financial section of the newspapers, nor are they the same on each type of property, nor do all apartments take the same rate. Clients are continually asking us this question. Without a doubt, this is one of the most controversial questions in appraising today. We have been asked to recommend articles or books on the subject that can act as a guide to the layman. Much has been written on the subject, but in no case have current examples been given as bench marks to guide the neophyte's thinking. Generally, the writings have been long, theoretical and noncommittal. It is with the knowledge of the pitfalls that will be encountered by any author setting down so-called bench marks that this bulletin is written.

Capitalization rates are not fixed. They vary with the times as well as with individual properties under consideration. Our Appraisal Bulletin of July 17, 1951, discussed capitalization rates in general as well as the increase in rates brought about by the change in interest rates due to the action of the Federal Reserve, which halted its conversion policy last year, and the concurrent action of the Treasury allowing the interest rates on long-term government bonds to rise. This bulletin will be devoted to the selection of specific rates for various types of properties.

As mentioned in the bulletin discussed above, there are two basic methods of estimating the capitalization rate - the "build-up" and the "comparative" method. The first part of this bulletin will deal with the "build-up" method. The "comparative" method will follow.

In this first instance we will consider the capitalization rate that should be applied to the most ultraconservative of investments. One of these examples could be the consideration of the land in the center of the 100% shopping district of a large city that was held in fee and which was improved with a proper (highest and best use) structure by the long-term lessee of the land. The improvements in this example are residual to the lessor upon expiration of the terms of the lease, and are pledged for performance of the said lease. It is hard to imagine an investment that is safer, more readily salable and one requiring less management. Consequently, a very low rate would be applied. By the build-up approach the following rates, which constitute the comprehensive capitalization rate, would appear reasonable.

Pure interest rate . . . . .	1.62%
Rate for nonliquidity . . . . .	1.00
Rate for management . . . . .	.20
Risk rate . . . . .	.30
Capitalization rate . . . . .	3.12%

An example of an extreme in the other direction could be the consideration of an old theater designed for legitimate stage productions in the dying section of a downtown business district. In this instance, we have a special-purpose building that must compete with modern-designed theaters in better locations. In addition, television is a threat to all entertainment houses. Because of the slope of the floors, such a structure can only be converted to other uses by expensive and extensive alterations. In this case we would probably arrive at a rate as follows:

Pure interest rate . . . . .	1.62%
Rate for nonliquidity . . . . .	2.00
Rate for management . . . . .	1.50
Risk rate . . . . .	8.00
Capitalization rate . . . . .	13.12%

In our opinion, practically all capitalization rates would fall between these ranges (3.12% - 13.12%) on today's market. It is up to the well-informed appraiser to decide the proper rate for each part that constitutes the capitalization rate. For pure interest, which remains constant on all properties for any given time, we prefer using the rate on 3-month Treasury bills, which are presently quoted at 1.62. The minimum rate for nonliquidity we use is 0.9%, which is the difference between the rates on short-term negotiable government instruments and long-term government bonds. The maximum we believe that can be used is approximately 2%, which we use on single-purpose properties which do not enjoy a ready market. The rate for management can vary, too, from a minimum of 0.2% to 1.5%. In the first example, management includes the initial commission for the lease negotiation and from that time on consists merely of banking the income. However, in the latter case it most likely would involve frequent leasing costs, costs of supervising frequent alterations to attract tenants, legal fees necessary to collect rents, etc. The risk rate is the item that will vary the most - from a mere 0.3% on the conservative investment of the first example to 8% on the latter. Actually, this rate can go higher than the 8% rate used. However, there are a sufficient number of speculators and uninformed investors in the market that prevent the rate from going much higher.

There are three elements in the risk rate that should be considered when estimating it, namely: (1) the general business and real estate trends during the remaining economic life of the subject property; (2) the trend of the specific line of investment or neighborhood; and (3) the trend of the specific property. Forecasting the general business trend is without a doubt the hardest. However, since real estate generally has a long life and holdings, as a general rule, are anticipated for an extended period, it is not too hard to anticipate the future. In the past, the

cycle of real estate activity, which is somewhat of an index to value, followed a more or less regular cycle of 18-1/3 years - roughly 8 years up and 10 years down. Furthermore, construction costs and values have fluctuated in a like manner above and below an increasing normal. The trend of a specific line, too, is difficult to forecast. This trend may include the trend of a neighborhood. The trend of a specific line would pertain primarily to properties that are single-purpose. Theaters would be an example where the trend of the specific line is much below the expected average. In considering the trend of a neighborhood, it is important to consider its age, its environs, and the future growth of its supporting area. The last element - consideration of the trend concerning the subject property - requires a study of the specific property, its age, condition, earning capacity, expenses, vacancy, its location within the neighborhood, etc. The first two elements may be excellent, but the subject improvements may be excessive in size, require too much maintenance, or be undesirable in the particular neighborhood. These items would generally increase the risk rate.

It should be remembered that underimprovements on a property are generally a better risk than overimprovements. The underimprovement takes on value from its neighbors, while an overimprovement loses value to its neighbors.

The late A. B. Kissack, M.A.I., of our organization believed that it was not necessary to increase the capitalization rate because a property was deteriorated and obsolete and approaching the end of its economic life. He believed that the risk involved in such an extremely depreciated property should be covered by adjusting the anticipated future income and that the capitalization rate should be the same as for a new property of the same type. We still believe this to be true, and an excellent method of application, but it requires more accurate estimates of future income, expenses and vacancy allowances than can be forecast with any degree of accuracy by the average appraiser.

For a well-designed and well-located 1-story store building, we would recommend using 6.7%, made up as follows:

Pure interest rate . . . . .	1.62%
Rate for nonliquidity . . . . .	1.10
Rate for management . . . . .	1.00
Risk rate . . . . .	3.00
Capitalization rate . . . . .	6.72 (call 6.7%)

The comparative method of estimating the capitalization rate is often considered the most accurate. The difficulty encountered most frequently in applying this approach is that complete information regarding recent sales of comparable properties is not available. To apply this method one must assemble the net income and the sales prices on all available recent sales of comparable property. It is important that the net income figures on each property be comparable, that is, computed in a similar manner, deducting the same items of expense and depreciation in each case. An example of this application follows.

Reference number	Date of sale	Net annual income*	Sales price
A	3/10/52	\$12,050	\$177,700
B	2/29/52	9,250	125,000
C	2/14/52	10,050	165,000
		<u>\$31,350</u>	<u>\$467,700</u>

Net income ÷ sales price = capitalization rate  
 \$31,350 ÷ \$467,700 = 6.7%

\*After depreciation.

The bench marks given in the two approaches for selecting the capitalization rates presented in this bulletin should be used merely as a guide. It is necessary to check the accuracy of the capitalization rates that are being applied at regular intervals. Both methods should be used, one as a check against the other. If there is considerable discrepancy between the two approaches, a more thorough check should be made to determine the correct rate. The comparative method, in our opinion, is the more accurate measure. However, many small offices throughout the country may often find that they do not have adequate information on current sales of comparable properties. Therefore, they may have to resort to the build-up method. If this be the case, it is necessary to check the fluctuations in interest rates. Many appraisers maintain currently charts showing the fluctuations in the rates of government bonds of various sorts, high-grade municipal bonds, Aaa corporate bonds, and all grades of corporate bonds. These are used to familiarize the observer with the activity in the money market.

  
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